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In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 941

THE D. W. KLEIN COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 99–120) is unreported. The opinion of the Circuit Court of Appeals (R. 159–168) is reported in 123 F. (2d) 871.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on November 28, 1941 (R. 168). The petition for a writ of certiorari was filed February 11, 1942. The jurisdiction of this Court is in-

voked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. The assets of a bankrupt corporation were bought at a bankruptcy sale by an individual, its sole preferred stockholder, who about a month later transferred them to the taxpayer (a new corporation), in return for its stock and the assumption by the taxpayer of the balance of the purchase price owed by the individual to the trustee in bankruptcy. The principal question presented is whether the taxpayer acquired the assets pursuant to a reorganization within the meaning of Section 112 (i) (1) of the Revenue Act of 1932, so that the basis of the assets in its hands is the same as it was in the hands of the bankrupt corporation. If there was no such statutory reorganization, the further question is presented whether the taxpayer's basis is limited to the cost of the assets to its transferor (the individual) under Sections 112 (b) (5) and 113 (a) (8) of the 1932 Act, and the retroactive provision of Section 213 (f) of the 1939 Act, or whether the taxpayer may increase its basis by adding to the transferor's cost the amount of the unpaid balance of the purchase price which it assumed.

2. Whether certain payments made by the taxpayer to creditors of the bankrupt corporation to establish credit and good will were properly dis-

allowed as deductions from income as "ordinary and necessary expenses" of the taxpayer within the meaning of Section 23 (a) of the 1932 Act.

STATUTES INVOLVED

The pertinent statutory provisions are set forth in the Appendix, *infra,* pp. 12–16.

STATEMENT

The facts, as found by the Board of Tax Appeals (R. 99–108), may be summarized as follows:

The Royal Cloak Company, an Iowa corporation, was organized in 1916 to sell women's and children's wearing apparel. It owned all of the stock, except two qualifying shares, of The Klein Clothing Company, an Illinois corporation, engaged in the sale of men's clothing. The outstanding common stock of the Royal Company all belonged to five brothers, who also owned all of the Class B preferred stock of the company. The company also had outstanding 450 shares of Class A preferred stock, which carried no voting rights; all of this stock belonged to Mrs. D. W. Klein, the wife of one of the brothers. The company operated stores in eleven cities in Iowa and Illinois. Its subsidiary, The Klein Clothing Company, operated in the Peoria store occupied by the Royal Company (R. 100–101).

In 1930 and 1931, following operating losses, the Royal Company closed three of its stores and sold a fourth. It desired to close all of its remaining

stores except the two at Burlington and Peoria. To accomplish this purpose, a plan was worked out whereby the assets of the Royal Company would be transferred to a new company; this plan, however, was abandoned upon the advice of counsel that such a transfer would not effect a cancellation of the leases for the stores which the company desired to close. Thereafter, upon the recommendation of counsel, an assignment of the company's assets for the benefit of its creditors was made to one Frankel as trustee. (R. 101.)

About two days after this assignment was made, however, it was learned that some of the creditors of the company planned to file a petition in bankruptcy against it in Iowa. Being anxious that the affairs of the company be administered in Peoria, Illinois, its principal place of business, its officers filed a voluntary petition in bankruptcy there. Frankel, the assignee for the benefit of creditors, was appointed receiver to take charge of the assets and to continue operation of the stores, and he subsequently became the trustee in bankruptcy. All of the stores, except those at Peoria and Burlington, were closed and the assets sold, with the exception of certain accounts receivable. The trustee continued to operate the stores at Peoria and Burlington until January 23, 1932. (R. 101–102.)

On January 25 and 26, 1932, the trustee offered for sale at public auction assets of the Royal Cloak Company consisting of accounts receivable and of

the merchandise, stock and fixtures of the Peoria and Burlington stores. These assets were bid in by an agent of Mrs. D. W. Klein for $45,625. On January 27, 1932, the trustee offered for sale the balance of the Royal Cloak Company's assets consisting of the stock of The Klein Clothing Company; these assets were likewise bid in by Mrs. Klein's agent, for $6,500. Both of these bids were approved by the court. On January 31, 1932, the agent assigned to Mrs. Klein all his interest in the bids. Mrs. Klein thereupon paid the trustee in bankruptcy $20,000 in cash and gave her promissory notes in the amount of $32,125 to cover the balance due on the purchase price. (R. 102–103.)

The D. W. Klein Company, taxpayer and petitioner here, was organized on February 22, 1932. On February 25, Mrs. Klein executed to the taxpayer a bill of sale of all the assets purchased from the trustee in bankruptcy, in consideration the taxpayer agreeing to issue to her its stock of the par value of $52,125 and to pay the $32,125 balance of the purchase price due from Mrs. Klein to the trustee in bankruptcy. On March 4, 1932, the taxpayer's directors accepted the bill of sale and authorized the issuance of the stock to Mrs. Klein.[1] Thereafter, taxpayer paid to Mrs. Klein the $32,125

[1] That stock, 2,085 shares of $25 par value common, issued to Mrs. Klein and her four nominees (other Kleins), is all of the outstanding stock of the taxpayer, except for some preferred stock issued in 1937 (R. 100).

due on her notes and she in turn paid it over to the trustee in bankruptcy. (R. 103.)

The assets acquired by the taxpayer from Mrs. Klein had a value at the time of the transfer of not less than $84,250. They were set up by the taxpayer on its books, as of January 25, 1932, at figures aggregating $168,512.97. (R. 104, 119.)

During the fiscal year ended January 31, 1933, the taxpayer paid certain amounts aggregating $7,909 upon various obligations which constituted claims against the bankrupt.[2] The payments (itemized in the Board's findings at R. 106–108) were in the main made to obtain credit or financing and to establish credit relations with merchandise houses. (R. 106–108.)

In arriving at the taxpayer's income tax liability for the fiscal year ended January 31, 1933, the Commissioner determined: (1) that, for the purpose of computing gain or loss on the accounts receivable and depreciation on the furniture and fixtures acquired by the taxpayer from Mrs. Klein, the taxpayer's basis was the cost of those assets to Mrs. Klein at the bankruptcy sales, $52,125; and (2) that the $7,909 paid by the taxpayer was not deductible as expenses or as additional cost of goods sold (R. 105–108). The Board sustained the Com-

[2] The distribution in the bankruptcy proceeding had amounted to approximately 30% of the proven claims (R. 108).

missioner's determination in these respects (R. 108–120) and the court below affirmed (R. 159–168).

ARGUMENT

1. The court below correctly held that the taxpayer did not acquire the assets of the bankrupt corporation in a reorganization under Section 112 (i) (1) of the Revenue Act of 1932 (Appendix, *infra,* p. 13) and that therefore the taxpayer was not entitled to use the bankrupt company's basis for those assets.

When the Royal Clothing Company went into bankruptcy, the equity of its stockholders, including that of Mrs. Klein as holder of the Class A preferred stock, was wiped out. Mrs. Klein acquired the assets of the bankrupt, not by virtue of her stock ownership, but by bidding them in for cash at the public sales held by the trustee. She then transferred the assets to the taxpayer in return for stock and the assumption by the taxpayer of the remainder of her obligation to the trustee. In this situation, it is plain, as both the Board and the court below held, "that there was no plan of reorganization carried through which included a continuation of the interests of the Royal Cloak Company or its stockholders in the petitioner, and that Mrs. Klein acted for herself alone" (R. 163). In the absence of the requisite continuity of a proprietary interest between the old and new companies, there can, of course, be no statutory reorganization.

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The decision of the court below in this case is not inconsistent with its own previous decisions in *Commissioner* v. *Kitselman,* 89 F. (2d) 458, and *Rex Manufacturing Co.* v. *Commissioner,* 102 F. (2d) 325, or in conflict with the decision of the Circuit Court of Appeals for the Sixth Circuit in *Commissioner* v. *Newberry L. & C. Co.,* 94 F. (2d) 447. Similar allegations of conflict were made in the petition for a writ of certiorari in *Mascot Stove Co.* v. *Helvering,* No. 564, present Term, seeking review of a decision of the Sixth Circuit in which it was held, upon substantially the same state of facts as are here presented, that no reorganization had taken place. See 120 F. (2d) 153. This Court, however, denied certiorari.[3] The distinction between the type of situation presented in the present case and in the *Mascot Stove* case, on the one hand, and the situation presented in the *Rex, Kitselman* and *Newberry* cases, on the other, are spelled out in our brief in opposition in the *Mascot Stove* case, pp. 8–9.

There is no basis for taxpayer's assertion that the decision below is in conflict with the decisions of this Court in *Helvering* v. *Alabama Alphaltic*

[3] The present case is even weaker for the taxpayer than the *Mascot Stove* case, because here Mrs. Klein owned the assets in her own right, without any obligation to transfer them to the taxpayer, for a period of about one month between her purchase of the assets at the bankruptcy sales and her transfer of them to the taxpayer (R. 119). Cf. *Bondholders Committee* v. *Helvering,* Nos. 128 and 129, present Term, decided February 2, 1942.

Limestone Co., No. 328, present Term, and in *Palm Springs Holding Corp.* v. *Commissioner*, No. 503, present Term, both decided on February 2, 1942. In those cases this Court held that requisite continuity of interest existed for a statutory reorganization because the creditors of the bankrupt transferor corporation, who alone had effective command over the disposition of its property, were the stockholders of the new transferee company. Here such continuity of interest is lacking since, as we have pointed out, Mrs. Klein had no equity in the bankrupt corporation and became owner of its assets solely by virtue of her purchase of them for cash at the trustee's public sales.

2. The court below properly rejected the taxpayer's alternative contention that its basis for the assets should be the cost to its transferor, Mrs. Klein, increased by the amount of her obligation to the trustee in bankruptcy which the taxpayer assumed (R. 164–166).

Under Section 112 (b) (5) and 112 (c) (1) of the 1932 Act, as originally enacted, Mrs. Klein would have realized income upon her transfer of the assets to the taxpayer in the amount of her liability to the trustee in bankruptcy which the taxpayer assumed. See *United States* v. *Hendler*, 303 U. S. 564. Accordingly, under Section 113 (a) (8) of that Act, the basis of the assets in the hands of the taxpayer would have been the cost to Mrs. Klein increased by the amount of the assumed

liability. Section 213 (f) of the Revenue Act of 1939, however, retroactively changed this rule and made the transfer tax free to Mrs. Klein; consequently, under the clear terms of Section 113 (a) (8), the basis of the property in the hands of the taxpayer is simply the cost to Mrs. Klein, without any increase by virtue of its assumption of Mrs. Klein's liability to the bankruptcy trustee. Taxpayer's contention (Pet. 15–16) that the subsequent payment of the assumed obligation by the taxpayer directly to Mrs. Klein removes this case from the application of Section 213 (f) is merely an assertion unsupported by authority and without foundation in the statutory language.

3. There is also no merit in taxpayer's contention that the decision below, in its application of Section 213 (f), conflicts with *Helvering* v. *New President Corp.*, 122 F. (2d) 92 (C. C. A. 8). Section 213 (f) was not there involved, and the holding was merely that the basis for property of a bankrupt concern bought in by an agent of the mortgage creditors and then transferred to a new corporation of which the creditors were stockholders, was the fair value and not the bid price of the property. Cf. *Boldholders' Committee* v. *Helvering,* Nos. 128 and 129, present Term, decided February 2, 1942.

4. The court below correctly upheld the Commissioner's refusal to allow the payments made by the taxpayer upon the obligations of the bankrupt as

deductions as ordinary and necessary expenses of the taxpayer, or as part of the cost of the goods sold (R. 166–167). Since this question was decided by the Board and by the court below on the particular facts of this case, there is no occasion for review by this Court, and the assertion (Pet. 16) of conflicts in this respect is without merit.

CONCLUSION

The case was correctly decided below. There is no conflict of decisions and the case presents no question calling for review by this Court. The petition should therefore be denied.

Respectfully submitted,

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